IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 16,341

JOE L. SCHMITT, JR., and HELEN M. SCHMITT, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

**Petition to Review a Decision of The Tax Court of the United States**

## REPLY BRIEF FOR PETITIONERS

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## TABLE OF CASES

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## REPLY BRIEF FOR PETITIONERS

Respondent in his brief has done little more than restate the findings and opinion of the Tax Court. He has made no effort to meet the specific arguments presented by petitioners which demonstrate that the Tax Court's ultimate findings to be erroneous and require that its decision be reversed. The principal argument advanced by the respondent is that the petitioner only transferred to the territorial assignees a license to *use* the Exact-O-Matic System. The respondent's position is untenable. The entire record, and more particularly, the written contracts

provided that the petitioner assign all of his rights in the Exact-O-Matic System without limitation of time to the assignees. As pointed out in page 6 of the petitioners' original brief, paragraph 2 of the Territorial Assignment of Patent specifically provides as follows:

> "Assignor hereby grants unto Assignee the exclusive right, privilege and franchise to use and sell the said Exact-O-Matic System (District, Unit A and Unit B), throughout the Territorial area described as follows:
>
> " * * * and to use, employ, and operate any and all methods, procedures, and processes covered by said Patents, Patents pending, Registration, and Copyrights, within and throughout the Territorial Area, and also any reissues or extensions thereof during the entire term of said Patents, Registrations, and Copyrights, subject, however, to the conditions and covenants hereinafter set forth. For the purposes of this agreement, the designation 'patent' is hereby defined to mean Patents, Patents pending, Registrations, Copyrights, and any oral or written agreement between the said 'Assignor' and Remington-Rand, Inc., a Delaware Corporation, heretofore or hereinafter issued to Assignor, relating to double entry machine bookkeeping methods, procedures, and processes."

The many cases cited in petitioners' original brief fully support the position that petitioner transferred "all substantial rights" in the System.

The reasons given by respondent at pages 18-19 of his brief, for his position that only a license to use the System was transferred were that the wiring unit remained the property of the petitioner and that the assignee could only sell or dispose of his interest in the System with petitioners' written consent. The respondent is in error in asserting that the wiring unit remained the property of the petitioner. The record shows that petitioner designed a general accounting wiring unit to be used in tabulating machines manufactured by Remington-Rand as a part of the Exact-O-Matic System. (R. 66-67) The general ac-

counting wiring unit which was designed by the petitioner is an integral part of the Exact-O-Matic System. The petitioner never transferred his property rights in the general accounting wiring unit to Remington-Rand, but under a letter agreement with Remington-Rand, his rights in the unit were recognized. (R. 149-150) In the Territorial Assignment of Patent petitioner reserved no special rights to the wiring unit. It was merely a part of the Exact-O-Matic System and could be sold or transferred by the assignee in the same manner as the balance of the System. However, the approval of the petitioner was required to transfer the entire Exact-O-Matic franchise. The testimony regarding the ownership of the general accounting wiring unit is set forth in the record at pages 120-128, and 130-135. There the petitioner repeatedly testified that the franchise holders received a wiring unit as an integral part of the Exact-O-Matic System. Accordingly, the respondent is in error in now taking the position that the wiring unit remained the property of the petitioner.

Respondent completely disregards all the cases cited in petitioners' brief which hold that the franchise may be transferred only with the written consent of the assignor. Respondent completely fails to discuss the many cases cited in petitioners' brief where Courts have held that sales took place despite the fact that many more rights were retained in those cases than in the case at bar.

The respondent at pages 19-20 and again at page 24 of his brief points to certain conditions subsequent in the Territorial Assignment of Patent Agreement and asserts that had the franchise holders failed to uphold the covenants, the petitioner would have been entitled as a matter of contract law to rescind the entire agreement. While there is considerable question as to the legal accuracy of this statement, the answer is that the Courts have repeatedly held that the possibility of reverter to the assignor because of conditions subsequent do not prevent the trans-

action from being a sale and the gain therefrom entitled to capital gains treatment. See cases referred to in pages 13 and 14 of petitioners' original brief.

At page 20 of his brief, respondent cites the case of *Bailey* v. *Commissioner,* ¶50,237 P-H Memo T.C., as supporting his position. The respondent states that in the *Bailey* case the taxpayer granted to an "independent company," much more broadly than is the situation in the instant case, the sole and exclusive right to make, use and sell certain inventions. Despite the fact that memorandum opinions of the Tax Court have limited value as a precedent, the statement made by the respondent that the transfer in the *Bailey* case was to an "independent company" is not true. The fact is that the transfer in the *Bailey* case was made to a corporation in which the taxpayer was the President and a majority stockholder since its organization. The opinion states:

> "We are satisfied that the arrangement between petitioner and his corporation was a license and not a sale under the original oral agreements and the first reductions to writing in prior years; and we have so held in the related case of William M. Bailey Company, 15 T.C. [(No. 65)], [¶15.65 P-H TC 1950], promulgated this day, where the question was whether the corporation was entitled under that agreement to deduct royalty payments as license fees paid for property of which it was not the owner.
>
> "Petitioner at no time contends that the final formal agreement of 1945 did any more than to incorporate the previous arrangements in a writing and to formalize them. * * * "

In the companion case, *William M. Bailey Company,* 15 T.C. 468, the corporation contended that for the years 1942 and 1943 it was entitled to deduct the payments to Bailey as royalties. The Court sustained the corporation's right to deduct the payments as royalties. In his 1946 Federal income tax return, Bailey reported the royalties received

in that year from the corporation as long-term capital gain. The facts in the *Bailey* case between related taxpayers not dealing at arms' length can have no application to the case at bar.

At page 21 of his brief the respondent states:

> "* * * taxpayer also retained the right to defend all patent infringement suits and agreed to pay the costs of such litigation. The retention of such a right, coupled with the obligation to pay the cost of litigation, is clearly persuasive evidence that the transferor has retained a substantial proprietary interest in the transferred property * * *"

Paragraph 12 of the Territorial Assignment of Patent provides: (R. 31)

> "(12) Assignors agrees to defend at his own expense any litigation arising within or without the territorial area challenging his right to use any of the aforesaid patents *to the end that all rights secured to Assignee herein may be preserved.*" (Emphasis supplied)

As can be seen from paragraph 12 the petitioner did not "retain" anything by this paragraph. There is no reservation of power or rights contained in the paragraph. The paragraph is analogous to a warranty of title or a covenant to defend title which is a common provision in most deeds of conveyances of real property. *First National Bank of Princeton* v. *U. S.*, 136 F. Supp. 818, 48 AFTR 1082. The provision was one designed to protect and safeguard the rights and interest of the assignee. It was not intended to reserve to the assignor any property or proprietary right in the Exact-O-Matic System which was at variance with the assignment to the assignee of the exclusive right, privilege and franchise to use and sell the Exact-O-Matic System throughout the territorial area described without limitation as to time. *Watson* v. *United States,* 222 F. 2d 689, 47 AFTR 925. In many licensing agreements the patentee often retains legal title for the purpose of defending or

prosecuting patent infringement suits. In a number of cases the Commissioner has attacked these assignment agreements as being licenses rather than sales. Commencing with the case of *Parke, Davis & Co.*, 31 B.T.A. 427 (1934), the Commissioner has consistently met with defeat in an effort to have such agreements declared mere licenses. The Courts have held that the retention of title for the purpose of defending or prosecuting infringement suits did not render an otherwise valid sale a license. See for Example: *Watson* v. *United States,* 222 F. 2d 689, 47 AFTR 925, *First National Bank of Princeton* v. *U. S.,* 136 F. Supp. 818, 48 AFTR 1082, *Roe* v. *United States,* 138 F. Supp. 567, 49 AFTR 585, *General Spring Corporation,* ¶ 53,257 P-H Memo T.C.

At pages 21-23 of his brief, the respondent argued that petitioner did not intend to divest himself of his ownership rights in the Exact-O-Matic System when granting territorial franchises. This assertion is based upon descriptive statement contained in an agreement made in December 1949 between petitioner and a corporation he organized known as the Exact-O-Matic System, Inc., an Arizona corporation. In that agreement the petitioner is described as "the sole owner of the entire right, title and interest in and to certain United States patents, patents pending," etc. referred to under the trade name, Exact-O-Matic System, Inc. The records shows that petitioner organized the corporation known as Exact-O-Matic System, Inc. for the purpose of using and operating the System in the State of Arizona. In addition, the corporation took over petitioner's obligation to train the personnel of the territorial franchise holders in the use of the System. The petitioner was the "sole owner" of the entire right to the Exact-O-Matic System for the State of Arizona. Several territorial franchises had been granted at the time the agreement was made in December 1949, but the agreement specifically provides that it is subject to the provisions and

limitations contained in Territorial, District, Unit "A", Unit "B" and Unit "I" franchises issued or to be issued. Accordingly, it can not be argued that this agreement expresses an intent on the part of the petitioner that is not consistent with divestiture of ownership rights in the Exact-O-Matic System under the Territorial Assignments of patent. In support of his argument the respondent there cited and quotes from the case of *Eterpen Financiera Sociedad* v. *United States*, 108 F. Supp. 100, 42 AFTR 831. The facts in the *Eterpen* case readily distinguish it from the case at bar. In the *Eterpen* case the taxpayer entered into a licensing agreement with Eversharp, Inc. and Eberhard Faber Corporation licensing its United States patents on a ball pointed fountain pen and writing ink for use in such pen for a period of years. At the same time, it entered into a separate option agreement granting the licensees an exclusive option to purchase for the area embraced in the licensing agreement the entire *right, title and interest* in and to the patents and patent applications covered by the license agreement for the lump sum of $1,500,000. Subsequently, Eversharp exercised the option and purchased the patent rights for a lump sum. The substance of the Court's holding was that the first agreement was intended as a mere licensing agreement; otherwise, the parties would not have excuted the option agreement providing for the purchase for a lump sum. Furthermore, the very fact that Eversharp exercised the option agreement showed that the license agreement constituted a mere license and not a sale. This case can have no application to the case at bar.

At page 25 of his brief the respondent states that it makes no difference why the taxpayer retains certain rights, but having chosen to do so, he is subject to the ordinary income tax rates. The respondent is wrong in stating that the reason for the retention of rights or provisions of an agreement make no difference. This is the same erroneous

concept that permeates the Tax Court's opinion. As pointed out at pages 14 and 15 of petitioners' original brief, the nature of the rights involved and the peculiarities inherent in each patent must be taken into consideration in determining whether all the substantial rights have been sold. See *United States* v. *Carruthers*, (CA-9 1955), 219 F. 2d 21, 46 AFTR 1626; *Lawrence* v. *United States*, (CA-5, 1957), 242 F. 2d 542, 50 AFTR 224.

At page 25 of his brief the respondent states:

> "* * * Indeed, taxpayer recognized that part of the income he derived from the franchise agreements was taxable at ordinary income rates when he reported his royalty payments as ordinary income. See *Switzer* v. *Commissioner*, 226 F. 2d 329, 333 (C.A. 6th). At no point during these proceedings has he suggested that this was incorrect, or offered any reason for treating the lump sum payments differently, and we submit that the lump sum payments stand on the same footing tax-wise as the continuing royalty payments, and are likewise taxable as ordinary income."

A similar statement appears in the Tax Court's opinion. (R. 155) However, this statement, coming from the respondent, must have been made with his "tongue in his cheek." In the case of *Edward C. Myers,* 6 T.C. 258 (1946), the Tax Court held that an inventor may receive capital gains benefits from the sale of his patent rights despite the fact that he was paid a royalty from the proceeds resulting from the sales of the patented product. The Commissioner first acquiesced in that decision. However, on March 20, 1950, the Commissioner withdrew his acquiescence as to royalties received from exclusive licensing agreements in Min. 6490, 1950-1 CB 9 and said:

> "4. The Bureaus has reached the conclusion that where the owner of a patent enters into an agreement whereby, in consideration of the assignment of the patent, or the license of the exclusive right to make, use, and sell a patented article, the assignee or licensee

agrees to pay to the assignor or licensor an amount measured by a fixed percentage of the selling price of the article so manufactured and sold, or amounts per unit based upon units manufactured or sold, or any other method measured by production, sale, or use either by assignee or licensee, or amounts payable periodically over a period generally coterminous with the transferee's use of the patent, such agreement, for income tax purposes, is to be regarded as providing for the payment of royalties taxable as ordinary income.

"5. Acquiescence in the decision of The Tax Court of the United States in *Edward C. Myers* v. *Commissioner* (6 T. C. 258), as it relates to the issue whether the payments involved therein were taxable as gain from the sale of property, is hereby withdrawn and non-acquiescence substituted."

In 1954, Congress to remedy the situation created by the non-acquiescence in the *Myers* case enacted Section 1235 (a) (12) of the Internal Revenue Code of 1954. In 1955 the Commissioner issued ruling 55-58, CB 97 interpreting Section 1235 to apply to payments received in 1954 and subsequent years, but not to apply to amounts received in the taxable years after May 31, 1950 and before January 1, 1954, and accordingly, announced that payments received by inventors for the taxable years after May 31, 1954 would be received as ordinary income. In response to this ruling of the Commissioner, Congress again in 1956 enacted Section 117 (q) of the Internal Revenue Code of 1939 in substantially the same terms as Section 1235 of the Internal Revenue Code of 1954 and provided that the statute should be applicable to any payments made pursuant to a transfer of patent rights in any taxable year beginning after May 31, 1950 regardless of the year in which the transfer occurred. This entire history is set forth in the case of *Rollman* v. *Commissioner,* (CA-4, 1957), 244 F. 2d 634, 51 AFTR 445. In view of the uncertainty of the law at the time the payments were received and the position taken by the Commissioner regarding royalty payments, it is unjustified to argue

that because the petitioner reported the royalty payments as ordinary income there was no sale.

## CONCLUSION

For the reasons stated above and in petitioners' main brief, the decision of the Tax Court should be reversed.

Respectfully submitted,

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